Debating China's Exchange Rate Policy

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More than two and a half years have passed since China announced a number of changes to its foreign exchange regime on July 21, 2005. During this period, the debate on the pros and cons of China's exchange rate policy, which had begun in earnest several years earlier, intensified. This new book takes stock of exchange rate policy in China and offers specific options for modifying China's exchange rate and capital account policies going forward. In their introductory chapter, Goldstein and Lardy frame these options in terms of two competing strategies: a "stay the course" policy and a bolder "three-stage" approach that seeks to reduce more rapidly the current undervaluation of the renminbi.

Key Challenges

China faces four key challenges in light of its undervalued exchange rate and the accelerating buildup of foreign exchange reserves: (1) maintaining a gradual pace of currency reform while trying to use monetary policy as an effective instrument of macroeconomic management; (2) reducing excessive reliance on external demand to sustain economic growth; (3) preventing the defense of the present currency regime from handicapping unduly efforts to strengthen and transform the banks into truly commercial entities; and (4) containing the risk of protectionism abroad in response to China's very large global current account surplus.

Monetary Policy Independence

In chapter 2, Eswar Prasad argues that a flexible exchange rate is required to deliver an effective monetary policy and further capital account liberalization, and without such a monetary policy and capital account regime it is much harder to achieve stable macroeconomic policies and an efficient and well-functioning financial market. In contrast, the two discussants of the Prasad paper, Jin Zhongxia and Shang-Jin Wei, conclude that the benefits of a more flexible exchange rate on monetary policy have been oversold in China's case. Fan Gang, a discussant of the introductory chapter by Goldstein and Lardy, similarly argues that while a freely floating exchange rate and capital account convertibility are desirable long-term goals, they cannot be achieved until certain preconditions are met.

Rebalancing Growth

In chapter 3, Bert Hofman and Louis Kuijs explain why a more sustainable growth path in China will require more reliance on services and less on industry, more reliance on factor productivity and less on capital accumulation, and more reliance on domestic demand and less on net exports. To illustrate how key imbalances in the

Chinese economy might evolve to the year 2035 under alternative policy packages, Hofman and Kuijs consider two scenarios. The first one broadly incorporates features of past growth (that is, investment-led and driven by industry) and simply extrapolates it forward. The results are disappointing. In contrast, a second scenario that incorporates five types of policies to help rebalancing yields much better outcomes. The exchange rate plays only a minor role in the second scenario.

In his comment on chapter 3, Kenneth Rogoff questions how Hofman and Kuijs can regard the exchange rate as unimportant when their model seems not to contain any meaningful monetary or financial sector. He argues that to obtain significant rebalancing without exchange rate adjustment, China would be required to perform "policy reform miracles" on numerous fronts.

Banking System

There is considerable agreement both inside and outside China on the evolution of China's banking system and on efforts to date to reform it. What is much less widely agreed on is how a more appreciated and more flexible exchange rate for the renminbi would affect banking reform. One popular view is that going much beyond the existing gradualist approach to currency reform would be too dangerous for the still fragile banking system. The bottom line of proponents of this view is that further strengthening of the banking system—and of the financial system more broadly—is a necessary precondition for bolder currency reform.

Others take an opposing view, seeing bolder currency reform as the ally rather than the enemy of banking reform. Champions of this view contend that capital account convertibility—not currency appreciation and flexibility—should await further strengthening of the banking system. Under this view, the right sequencing of reforms is to continue with banking reform and to move now to reduce significantly both the undervaluation and inflexibility of the renminbi but to wait until China's financial system is on stronger footing before opening up too widely the doors on capital outflows.

External Adjustment, Global Imbalances, and the Rising Risk of Protectionism

China's exchange rate policy also carries important implications for China's own external adjustment, the correction of global imbalances, public policy toward sovereign wealth funds (SWFs), the operation of the international exchange rate system, and efforts to maintain forward momentum on globalization. In this regard, among the most interesting issues in the ongoing debate are the following:

- Given the wide range of estimates of renminbi misalignment, can one be confident that the renminbi really is seriously undervalued?
- If China did implement a sizeable revaluation/appreciation of the renminbi, would it be effective in reducing substantially China's large global current account surplus?
- Would the costs of a large renminbi revaluation be prohibitively high?
- What explains the large surge in China's current account surplus between 2004 and 2007?

- Will the effect of renminbi revaluation on global imbalances be larger (smaller) than sometimes assumed because it will (not) lead to sympathetic revaluations in other Asian and emerging-market currencies?
- With China's reserves topping $1.5 trillion at year-end 2007 and with the recent establishment of its own SWF, what will be the impact, and what principles should guide the fund's operations?
- Should the International Monetary Fund (IMF) regard China's large-scale, prolonged, one-way intervention in exchange markets since 2003 as currency manipulation, and how should IMF exchange rate surveillance be conducted going forward?
- Are the several currency bills now before the US Congress a serious threat to open markets, or are they a "third best" policy response to a "beggar-thy-neighbor" exchange rate policy?

In chapter 4, William Cline and John Williamson survey many existing estimates of the **equilibrium value of the renminbi**. They find that the literature offers widely varying answers. At the same time, only one of the 18 studies in their survey concludes that the renminbi is overvalued. The average estimates indicate substantial renminbi undervaluation—on the order of 20 percent for the real effective exchange rate and 40 percent for the nominal bilateral renminbi-dollar exchange rate. Also, they find that renminbi undervaluation has been increasing over time, with a 17 percent real effective appreciation needed in studies using data for the 2000–2004 period versus 27 percent for studies based on data for the 2005–07 period.

In chapter 5, Edwin Truman examines the accountability and transparency of the **China Investment Corporation** (CIC). Given the actual and potential size of the CIC, as well as China's growing weight in the international financial system, Truman suggests that the Chinese authorities should aim to place the CIC at the top league of SWFs. He explains that for China the basic question is what to do with reserves once they are there. He argues that the preferable approach to managing excess foreign reserves is to apply strict economic and financial criteria and to maximize return over a relevant time horizon, subject to risk management constraints. The rest of the world will hold China responsible for its actions to a greater extent than it would a country with much smaller cross-border assets, and the Chinese authorities, so Truman opines, should get used to it. He counsels that now is the time for China to take the lead in helping to develop a set of best practices for SWFs.

In chapter 6, Gary Clyde Hufbauer and Claire Brunel explain that the three leading **congressional currency bills** have five features in common: They would eliminate "intent" in determining whether or not manipulation or misalignment has taken place; they invoke unilateral and multilateral trade remedies if the offending country does not act to correct the manipulation/misalignment; they instruct the US Treasury to make a forceful case in the IMF; they set out deadlines for action, ranging up to 360 days; and some of the bills contain waivers that delay or override US remedies. Hufbauer and Brunel reach four main conclusions:

- First, as stand-alone measures, congressional currency bills are unlikely to have much effect in persuading Beijing to implement a faster appreciation of the renminbi; however, multilateral pressure could be more effective in inducing action in the right direction.

- Second, trade remedy measures, sought in the World Trade Organization or under US laws, are best justified as levers to induce more forceful IMF action and to focus Beijing's attention on currency issues.
- Third, if an enlarged congressional voice on currency issues is heard only in exceptional circumstances, it may be helpful; on the other hand, if congressional committees continually pressure foreign countries over matters like the size of US bilateral trade imbalances, they could severely disrupt the international system.
- Fourth, since congressional currency legislation could spawn copycat legislation abroad, Congress should limit trade measures to situations where the foreign country is a major commercial player, is manipulating its currency via large-scale, persistent, one-way intervention as determined by the IMF, and is both running a large global current account surplus and has accumulated international reserves beyond an adequate level for prudential purposes.

In chapter 7, Takatoshi Ito examines the influence of the renminbi on exchange rate policy in other Asian economies. He explains that many Asian economies are reluctant to see their currencies appreciate too much, lest they lose undue competitive advantage to China, while China itself worries that much appreciation of the renminbi—if not matched by other Asian currencies—will result in excessive job losses in its export industries. He proposes the establishment of an **Asian currency unit** (ACU), plus a commitment by each Asian economy to aim at a stable relationship between its currency and the ACU, as a possible solution to this regional coordination problem.

In comments on chapter 7, Yung Chul Park concludes that so long as the yen remains a free floating currency and so long as China remains reluctant to revalue significantly its currency, a regional currency unit will be of little use as a surveillance indicator for coordination of exchange rate policy. Jean Pisani-Ferry postulates that Europeans are probably slower to react to external developments than Americans but also that an increasingly active European stance on China's exchange rate policy is in the cards—especially with the euro's sharp appreciation against the US dollar.

In chapter 8, Michael Mussa appraises **IMF surveillance** toward China's exchange rate policies. He contrasts the good job that the Fund has done in recognizing and addressing the problem of global payments imbalances (including the correction of the large US global current account deficit) with the "catastrophic failure" on surveillance of China's exchange rate policies. Steven Dunaway responds to Mussa's criticism, arguing that the main difference between the IMF and the Chinese authorities is on the speed of implementation of policies for rebalancing the Chinese economy, including removing the distortions associated with the current exchange rate regime. In her contribution to the volume, Wu Xiaoling sets forth the rationale for China's more gradualistic approach to exchange rate adjustment and other rebalancing policies.

Lawrence H. Summers, in his comments in chapter 9, is—like Mussa—highly critical of the Fund's performance. He characterizes the job that the Fund has done on this matter over the past four years as "…indefensible" and argues that the Fund's "culture" on exchange rate surveillance clearly needs to change. C. Fred Bergsten reinforces the view that China is violating IMF rules on competitive undervaluation and discusses the role the IMF might play in the event that a trade case focusing on the value of the renminbi is brought to the World Trade Organization.

Policy Options

What options do Chinese authorities have going forward? Goldstein and Lardy present the options in terms of two competing approaches: a "stay the course" strategy and a "three-stage" approach.

A **stay-the-course** strategy would contain the following key elements: The renminbi would continue to be allowed to appreciate at a moderate but controlled pace against the dollar—say 5 to 8 percent a year. The scale of China's exchange market intervention would control the pace of renminbi appreciation. Coming on top of the 15 percent nominal appreciation already achieved between July 2005 and January 2008, this would produce a nontrivial cumulative appreciation vis-à-vis the dollar over the next few years—presumably enough to keep foreign criticism at bay. Several substitutes for larger exchange rate appreciation, such as reduced value-added tax rebates and less favorable tax and tariff treatment for exporters, would continue to be employed to put upward pressure on export prices and/or to reduce the profitability of exporting. Also the central government would lean harder on both banks and local authorities not to finance or expand production in industries with clear excess capacity. More foreign buying trips could be arranged to publicize Chinese purchases of big-ticket US exports (e.g., Boeing aircraft). If China's global current account surplus and reserve accumulation prove more resistant to these measures than expected, restrictions on capital outflows can be liberalized somewhat further. The daily fluctuation band for the renminbi vis-à-vis the dollar, which was increased from 0.3 to 0.5 percent in May 2007, could also be increased to, say, 0.8 percent, so as to increase uncertainty for speculators betting on renminbi appreciation.

However, such small and gradual policy responses are not likely to be effective because renminbi undervaluation and China's external imbalance are much larger than they were, say, four years ago. The size and duration of the problem call for a bolder approach that would permit China to catch up in correcting its very large external disequilibria, while still keeping a lid on domestic social pressures. Goldstein and Lardy label it the **three-stage approach** to currency reform. In stage one, to begin immediately, China would undertake a 15 percent revaluation/appreciation of the renminbi (from its existing level). In stage two, the government would allow the renminbi to continue to float upward over the next several years, albeit at a gradual pace, say, 6 to 8 percent a year. And in stage three, say, four to six years down the road, intervention in the exchange market, along with sterilization operations, would be reduced still further, and the daily fluctuation limit on the renminbi would be dropped, so that the renminbi became essentially "floating."

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